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No. 182

In the Supreme Court of the United States

OCTOBER TERM, 1942

O'BRYAN BROTHERS, INC., PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 42–46) is reported in 42 B. T. A. 18. The opinion of the Circuit Court of Appeals (R. 88–91) is reported in 127 F. (2d) 645.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 16, 1942 (R. 87). The petition for a writ of certiorari was filed on June 27, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer is entitled to an income-tax deduction for a so-called bad debt charged off during the taxable year as not recoverable because it had released a part of the security therefor.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved herein are set forth in the Appendix, *infra,* pp. 10–12.

STATEMENT

This case involves a deficiency in income tax of $11,630.88 and excess profits tax of $1,104.41 claimed from O'Bryan Brothers for the year 1933 (R. 49). The facts may be summarized as follows:

Taxpayer is a Tennessee corporation engaged in the manufacture of work clothes. T. P. Kennedy, Sr., taxpayer's president prior to 1933 and the owner of 1,308 shares of its 1,500 shares of common stock, between 1919 and 1932 withdrew on an open account with the corporation large sums of money aggregating $206,011.51. No notes were given for these withdrawals and no interest was charged on taxpayer's books. (R. 36, 88.) Taxpayer's books showed this amount due at the end of 1933 (R. 37).

At the end of 1931 taxpayer owed the American National Bank of Nashville approximately $145,000 and the bank insisted upon security to

the corporation on account of the indebtedness of Kennedy, Sr., to taxpayer. Kennedy, Sr., accordingly executed a 30-day promissory note for $204,007.56 to taxpayer, and as collateral pledged his entire holding of common stock in the taxpayer corporation and executed and delivered a deed of trust upon certain real property owned by him and appraised at $35,000. The note and collateral were at once assigned to the bank as security for taxpayer's debt to the bank. No attempt was made by taxpayer to collect the note and it was not entered upon taxpayer's books. (R. 37, 88–89.)

In March 1932, the bank assumed management of taxpayer's affairs. Kennedy, Sr. was removed as president and T. P. Kennedy, Jr., formerly one of the vice presidents and manager of production, assumed management of the corporation. In November he was made president at the instance of the bank, which also suggested that he be given 51% of the common stock of taxpayer as an inducement to continue in the management. This was contingent upon taxpayer's consent to release the stock as security. Accordingly, on June 5, 1933, 751 shares of common stock belonging to Kennedy, Sr. were issued to Kennedy, Jr., with the consent of Kennedy, Sr., the bank and taxpayer; taxpayer then wrote down the indebtedness of Kennedy, Sr. to $70,000, charged off

upon its books the balance of $138,567.20 as a bad debt, and claimed a deduction of this amount in its income and excess profits tax return for 1933. (R. 38, 89.)

The disallowance by the Commissioner of Internal Revenue (R. 42) of this deduction was sustained by the Board of Tax Appeals. (R. 44, 89.) The Board's decision was affirmed by the court below. (R. 87, 91.)

ARGUMENT

In the year 1933, taxpayer held a note for $204,007.56 secured by collateral (R. 37). Taxpayer contends that that part of the collateral which consisted of its own shares of stock had declined in value so that the total collateral was worth less than the amount of the debt, and that, accordingly, when it surrendered part of this collateral to the debtor in the year 1933, it was entitled under Section 23 (j) of the Revenue Act of 1932 (*infra,* Appendix) to a deduction for a partially worthless debt, equal to the alleged value of the surrendered collateral (Pet. 4; Br. 9). The Board of Tax Appeals found that the collateral surrendered exceeded the amount of the indebtedness and that no part of the indebtedness was worthless (R. 44). The court below affirmed the Board, holding (R. 89–90) that a taxpayer may not by its own act render a collectible debt uncollectible, charge off the debt as worthless, and

then deduct it from income for purposes of taxation.[1]

The issues were correctly decided and present no questions concerning which there is a conflict of decisions or which warrant further review.

1. Whether or not the debt could have been collected in full at the time of the surrender depends upon the value of the collateral and the financial condition of the debtor. For this reason one of the two issues which the taxpayer asks this Court to review relates to the question of the value per share of the stock which served as collateral. The concurrent findings of the Board of Tax Appeals (R. 44) and the court below (R. 89) that the stock was worth $150 per share, and not, as taxpayer contends, $62.81 per share, are plainly supported by substantial evidence[2] and do not call for further review by this Court.

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[1] The Commissioner contended before the Board of Tax Appeals and the court below that the withdrawals by Kennedy, Sr., were in the nature of dividends and the Board stated that while there may be merit in this contention (See *Lincoln Nat. Bank* v. *Burnet*, 63 F. (2d) 131 (App. D. C.); *Peoples Gin Co., Inc.* v. *Commissioner*, 118 F. (2d) 72 (C. C. A. 5); *Faris* v. *Helvering*, 71 F. (2d) 610 (C. C. A. 9), certiorari denied, 293 U. S. 584) it preferred to dispose of the issue upon the assumption that an indebtedness existed (R. 43).

[2] It is undisputed that taxpayer's earnings amounted to $54.82 a common share (the par value of the stock being $100 a share) without regard to preferred stock and the deduction under consideration; the balance sheets for 1931, 1932, and 1933 indicated that the stock had a book value of $159.27, $166.25, and $128.95 per common share, without

Since the value of the stock must therefore be accepted as being $150 per share, the total value of the 1,308 shares held as collateral security was $196,200. In addition, the debt was secured by certain real estate which had a value of $35,000 (R. 37). Accordingly, the Board's finding that the collateral securing the indebtedness had a value in excess of the debt, which aggregated $206,011.51 (R. 44), is also plainly supported by substantial evidence.

2. The sole remaining issue, therefore, is whether taxpayer, owning a note fully secured by collateral, may, by surrendering part of the collateral to the debtor, claim a deduction for a partially worthless debt. The court below correctly decided that taxpayer could not.

A taxpayer is not entitled to the allowance of a bad debt deduction unless he has made an effort

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attributing any value to the taxpayer's trademark and good will. (R. 36, 44.) In addition, the taxpayer had paid its majority stockholder a salary and bonus of $35,000 per year (in addition to the substantial withdrawals previously mentioned from 1925 through 1930); had paid dividends of 8% on its preferred stock, and dividends of 5% or 10% on its common stock for most of these years. While Kennedy, Jr., president of the corporation, stated that the stock had no market value (R. 44), the Board was not required to accept this testimony (*Dayton P. & L. Co.* v. *Commissioner*, 292 U. S. 290, 298), as opposed to other evidence in the record indicating that the stock had substantial value, particularly in view of the fact that the taxpayer itself valued the stock at approximately $62.81 per share in claiming the deduction (R. 44).

to collect his debt. See Article 191 of Regulations 77. (Appendix, *infra,* p. 10.) A taxpayer may not forgive an indebtedness while his debtor is able to pay, or surrender collateral having value and then claim a deduction. See *Uhl Estate Co.* v. *Commissioner,* 116 F. (2d) 403 (C. C. A. 9); *American Felt Co.* v. *Burnet,* 58 F. (2d) 530 (App. D. C.).

The cases upon which taxpayer relies (Br. 9–11) are not to the contrary. As the court below pointed out (R. 90), the case of *Deeds* v. *Commissioner,* 47 F. (2d) 695 (C. C. A. 6), which the taxpayer cites as conflicting (Br. 11), is distinguishable. There the debtor was insolvent and the debt was uncollectible when the taxpayer surrendered the note to the debtor. The same factor distinguishes *Johnson, Drake & Piper, Inc.* v. *Helvering,* 69 F. (2d) 151 155, 156 (C. C. A. 8), certiorari denied, 292 U. S. 650. Cf. *Stranahan* v. *Commissioner,* 42 F. (2d) 729, 732 (C. C. A. 6), certiorari denied, 283 U. S. 822. And in any event, the taxpayer here did not release Kennedy, Sr. from the debt or any part of it, but rather continued to use the note secured by the rest of the stock as security for its own indebtedness to the bank (R. 37). The taxpayer clearly failed to overcome the Commissioner's determination that the debt was not worthless. See Section 23 (j) of the Revenue Act of 1932, and Article 191 of Treasury Regulations 77 (Appendix, *infra,* p. 19); *Stranahan* v. *Commissioner,*

supra; Higgins v. *Commissioner,* 312 U. S. 212, 218.

But taxpayer urges that a deduction for a bad debt to the extent of the value of the surrendered collateral is allowable in every case where the surrender is involuntary, that is, under economic compulsion, even though the total value of the collateral at the time of the surrender equals the debt (Br. 8–9). The cases cited by taxpayer do not support this contention, but involve other sections of the statute or present differing facts. Thus *Commissioner* v. *Wright,* 47 F. (2d) 871 (C. C. A. 7), involved a loss claimed by a stockholder on the surrender of his stock to the corporation to be paid as compensation to a new manager;[3] the court held that the surrender was not a capital contribution but in effect was a sale of the stock for a valuable consideration, namely, the acquisition of the services of the manager. See *City Builders Finance Co.* v. *Commissioner,* 21 B. T. A. 800. *Commissioner* v. *Burdick,* 59 F. (2d) 395 (C. C. A. 3) (Pet. 5; Br. 10), also involved a loss based upon a sale of most of the taxpayer's stock to another person who furnished money to pay the corporation's debts in connection with a capital reorganization. The case is not applicable here.

In any event there was not an involuntary re-

[3] The bad debt and loss provisions of the statute are mutually exclusive. *Spring City Co.* v. *Commissioner,* 292 U. S. 182, 189, rehearing denied, 292 U. S. 613.

lease in this case. The Board found that the release of the security in connection with the employment of Kennedy, Jr., was subject to the "consent of O'Bryan Brothers," that "All parties to the transaction agreed to the proposition * * *" (R. 38), and that the taxpayer "voluntarily relinquished collateral securing the indebtedness, thereby contributing to the partial worthlessness thereof * * *" (R. 43). It is plain, therefore, that taxpayer voluntarily agreed to the arrangement, which all parties, including taxpayer, considered to be beneficial to taxpayer. There was thus no compulsion, except in the sense that the best interests of the corporation appeared to require the release of the stock.

CONCLUSION

The decision below is correct. There is presented neither an important question of law nor a conflict of decisions. It is, therefore, respectfully submitted that the petition should be denied.

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